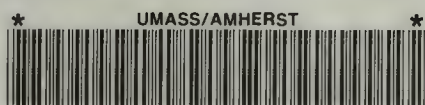


The Benefits of Pooled Financing for School Building Assistance Borrowing

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The School Building Assistance Program Restructuring Legislation filed by the Cellucci/ Swift Administration provides for a pooled financing program for school borrowing. Given the fact the Commonwealth contributes on average 69% of the debt service costs to communities, a pooled financing borrowing structure is the most efficient way of accessing the capital markets, reducing debt service costs for both the Commonwealth and the communities. This is why many other state-supported local infrastructure assistance programs, such as those in Illinois and Michigan, have adopted a pooled financing structure. A pooled structure will produce savings in many ways.

Lower Costs of Issuance

Many of the costs of issuing bonds, such as printing costs, bond counsel, and rating agency fees, do not vary significantly with the size of the issue. Most communities also must purchase bond insurance to market their bonds. A pooled issuance would need no bond insurance and could spread fixed costs over a much larger principal amount, reducing the cost to each community.

To determine the savings attributable to lower costs of issuance, the Executive Office for Administration and Finance reviewed projected costs of issuance for the current School Building Assistance wait list with the costs of issuance of two pooled deals. The analysis assumed that localities would have costs of issuance of 1% of their total issue or \$200,000, whichever was less. These costs did not include insurance and averaged 0.83% for the entire waiting list or \$6.4 million.¹ The estimated costs of issuance of the pooled program included paying for local bond counsel for local borrowers and ratings by three rating agencies. The analysis assumed two transactions of roughly \$400 million, enough debt to finance the entire wait list of projects approved for fiscal year 2000. The total costs of issuance for both transactions were projected to be \$5.3 million or 0.69%. Therefore, a pooled program would save about \$1.1 million in costs of issuance each year.

As noted, these savings do not include the costs of bond insurance, which can add more than 0.4% to the costs of issuance. Insurance does lower the interest expense communities would need to pay, so we did not include it as part of the costs of issuance analysis. However, it should be noted that in many instances where cities and towns receive rates competitive with larger and higher rated issuers like the Commonwealth, these communities have often had to pay for the lower interest rates with significant insurance premiums.

Lower Debt Service Costs

Since the Commonwealth pays on average 69% of the financing costs for debt issued pursuant to the School Building Assistance Program, this debt should be rated at or close to the Commonwealth's rating. This would be particularly true under the Cellucci/ Swift legislation since it provides that the Commonwealth would be the paying agent for almost all debt service, either through the School Building assistance appropriation or a local aid offset. Unfortunately,

¹ Fleet Securities, Incorporated reviewed 12 transactions that occurred between November, 1999 and March, 2000 and determined that these transactions had costs of issuance averaging 0.81%, not including insurance.



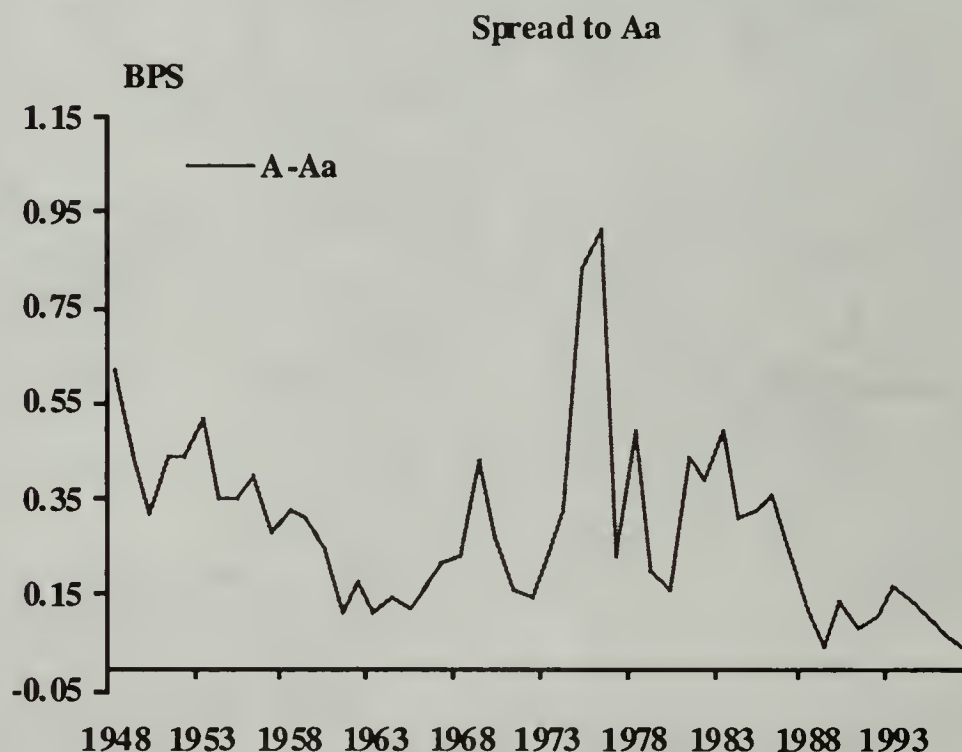
under the current system, borrowers do not get the benefit of the Commonwealth's Aa2/AA-/AA-rating because they must borrow on their own. For the vast majority of the Commonwealth communities, this means higher borrowing costs for the communities and higher subsidy costs for the Commonwealth. Below is a table indicating the different rates issuers with differing credit ratings might be expected to receive:

	10 year rate	Basis Point Savings
Aaa	5.275%	-0.10%
Aa1	5.375%	0.00%
Aa2	5.375%	0.00% Commonwealth's Credit
Aa3	5.375%	0.00%
A1	5.450%	0.08%
A2	5.450%	0.08% Median Mass. Community's Credit
A3	5.500%	0.13%
Baa1	5.625%	0.25%
Baa2	5.700%	0.33%
Ba2	6.000%	0.63%

Source: Lehman Brothers, Rates as 2/29/00

Two hundred ninety-eight communities, or 85% of those in Massachusetts, are rated at the single A level or worse. Allowing these communities to borrow at the Commonwealth's rate could save at least 8 basis points and up to 60 basis points due to improved credit ratings alone. This savings exists even though credit spreads (the interest rate benefit received by more highly rated debt) are at historically low levels.

Credit Rating Interest Rate Spreads (A-Aa) 1948-1997



Source: Moody's Municipal & Government Manual, 1998, vol. 3

If credit spreads returned to the levels of the early and mid-1980s, the benefit of the improved credit rating would be three to four times its current value. The analysis of the 2000 waiting list



indicates that savings from just improving local credit ratings to that of the Commonwealth would be another \$450,000 per year or \$9 million over the life of the bonds, even with today's narrow credit spreads. This analysis includes communities with higher ratings than the Commonwealth and those that benefit from the preferential treatment accorded small or "bank-qualified" issuers.²

Local issues do benefit from a strong market of local buyers, who receive both a federal and a state tax-exemption for municipal debt. The retail market in which local issues are usually sold is also less price-sensitive than the larger institutional market. Yet a pooled issuance has benefits that might offset these advantages. By utilizing a statewide issuer, creating a diversified pool of Massachusetts credits, and augmenting the state's School Building Assistance appropriation with a local aid intercept for the balance of the debt service, a pooled issue would present a very strong package to the capital markets that could achieve interest rates even lower than those usually received by Aa2 credits. This is because large investors in Massachusetts debt, such as mutual funds and insurance companies, have limits on the amount of debt they can hold in their portfolio from any one issuer. The pooled program would be a new, recognizable investment vehicle that these large investors could purchase outside those limits, lowering the interest rate. A pooled program would also create what investors call "liquidity," or the ability to buy and sell the bonds regularly on the secondary market. Liquidity is essential to large institutional investors, and few local bonds have such liquidity. The lack of liquidity for a debt issue often results in a "liquidity premium." The cost of the liquidity premium may compensate the pooled program for the benefits of selling to less price sensitive retail buyers.

The benefits of having a higher credit rating and more liquidity produce savings today, but become much more valuable during periods of rising interest rates and falling bond prices. In such an environment, smaller issues will have difficulty selling at all. As noted, most small issues require bond insurance. This is because the retail market, while being somewhat price insensitive, is very wary of credit risks. In difficult markets, such insurance will be more expensive or not available at all. A larger, more established issue will still be able to access the markets at a reasonable interest rate in almost any market conditions.

Ability to Take Advantage of Refunding Opportunities and Sophisticated Financing Techniques

Another benefit of the pooled program is its ability to take advantage of refunding opportunities and innovative financing techniques. A refunding occurs when interest rates drop and a borrower issues new debt at a lower rate to retire the higher rate old debt, thereby generating savings. Refunding debt involves transaction costs, so it only makes sense when the savings will be in excess of those transactions costs. As in an initial sale, many of those transaction costs are fixed, so a larger issue increases the likelihood that the issuer can take advantage of interest rate declines to refund debt. Moreover, smaller issues tend to have higher call premiums and more restrictive call provisions than larger transactions. The typical savings threshold for performing a refunding is 4%. Assuming there will be one opportunity to refund debt issued by the pool over the life of the bonds, and assuming about half of each issue will be outstanding when the opportunity occurs, the ability to refund debt efficiently can be worth as much as \$16 million. Prorating this across the life of each issue, these potential savings would equate to about \$800,000 per year.

A large pooled issue could also take advantage of commonly used sophisticated financing techniques like floating-to-fixed swaps, forward contracts for construction funds, and Qualified

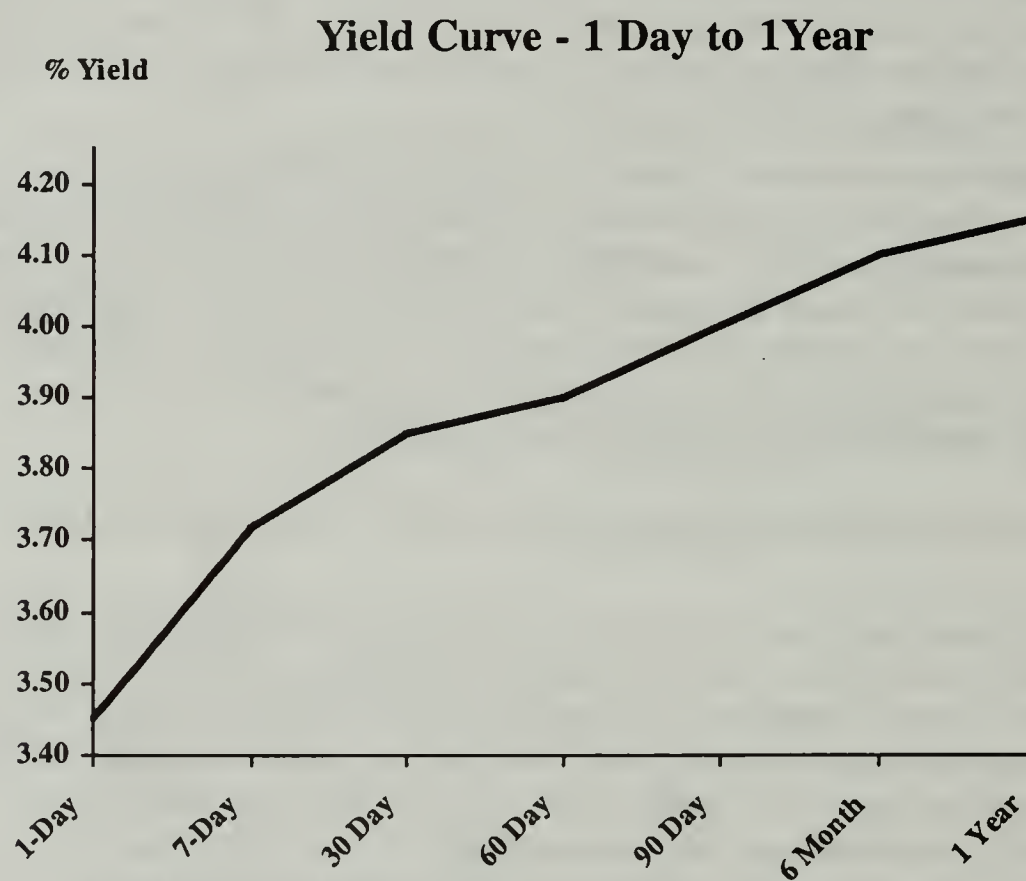
² Bank qualified issuers can only issue \$10,000,000 in debt annually.



Zone Academy Bonds or QZABs.³ The cost of structuring these deals often includes a large fixed component as well, so once again, significant issuance size is required to make these techniques worthwhile. Under different market conditions, these techniques can render different savings figures. For illustrative purposes, we can assume one issue each year utilizes a fixed-to-floating swap, where the pooled program would issue floating rate debt and then contract with a financial institution or “counter-party” for that entity to pay the variable interest payments. In return, the pooled program will pay a fixed interest payment to the counter-party. These transactions often save 20 basis points, or an additional \$500,000 annually if applied to only half of the pooled issuances.

More Efficient Short-term Borrowing

Currently, cities and towns financing construction with short-term financing must issue notes with maturities of approximately one year. This is because they do not have access to commercial paper financing vehicles that can access lower rates at the shorter- end of the yield curve. Commercial paper programs provide short-term financing in the 1-day to 270-day range, which as the graph below indicates, costs less in interest than the one-year note rate.



Source: Bear Stearns, Rates as of March 23, 2000

Yet commercial paper programs require large volume and a sure source of permanent financing. With a pooled financing program for the permanent School Building Assistance Program debt, the financing entity could easily set up a commercial paper program to provide construction financing prior to the issuance of long-term bonds. This will help communities with any timing

³ Swaps allow issuers to access the lower variable rate credit markets without giving up the certainty of fixed rate payments. Forward contracts allow for the buying and selling of funds for delivery at a point in the future. Qualified Zone Academy Bonds are new tax credit vehicles created by the Treasury Department to fund school building. Although 27 Massachusetts school districts are eligible for 0% financing through the issuance of QZABs, none have taken advantage of the program to date. Because of the complexity of the tax credit vehicle, issuance of QZABs has mostly occurred where states have had significant involvement.



issues the creation of the pooled program might create for them, as well as provide up to 50 basis points of savings for each year that they are borrowing short-term. Assuming half of the projects access this commercial program for an average of a year, these savings would equal \$2 million each year. Since the legislation filed by the Administration proposes to no longer reimburse for short-term borrowing costs, all the savings of the commercial paper program would accrue to the localities.

Savings Summary

Based on two transactions of \$400 million each, a pooled financing program could provide savings as follows:

Source of Savings	Annual Savings	Savings Over the Life of the Bonds
Costs of Issuance/ Insurance	1,000,000	1,000,000
Credit Improvement/Insurance Cost Avoidance	450,000	9,000,000
Retail Market Premium	-500,000	-10,000,000
Liquidity Premium	500,000	10,000,000
Refunding Opportunities	800,000	16,000,000
Sophisticated Financing Techniques	500,000	10,000,000
Commercial Paper Access	2,000,000	2,000,000
Total	4,750,000	38,000,000

Putting aside savings from refundings and innovative financing techniques, which may have varying effects on different communities, savings for selected projects on the existing wait list could be as follows:

Source of Savings							
District	Local Bond Rating	Estimated Issuance Size	Commercial Paper Access	Credit Improvement	Costs of Issuance	Total Savings Year 1	Total Savings For Life of the Bonds
Athol-Royalston New Middle	A3	12,742,036	63,710	11,031	47,692	122,433	332,012
Boston Latin	Aa3	29,882,050	149,410	-	13,024	162,434	162,434
Brockton Belmont St. Elementary	Baa2	15,072,547	75,363	34,059	56,414	165,836	812,952
Fall River North End Elementary	Baa2	16,378,143	81,891	37,009	61,301	180,201	883,371
Framingham Cameron Middle	Aa3	14,430,308	72,152	-	54,011	126,162	126,162
Greenfield Middle	A3	11,791,939	58,960	10,208	44,136	113,304	307,256
Hanson Middle School	A3	14,163,015	70,815	12,261	53,010	136,086	369,037
Holliston Miller Elementary	A1	30,935,963	154,680	16,052	(37,360)	133,372	438,368
Melrose Lincoln Elementary	A2	10,332,002	51,660	5,361	24,046	81,068	182,930
Pioneer Valley High School	A	14,969,409	74,847	7,768	56,028	138,643	286,225
Reading Coolidge Middle	Aa3	9,419,673	47,098	-	21,923	69,021	69,021
Salem Bates Elementary	A1	9,561,224	47,806	4,961	35,786	88,554	182,817
Westford Academy	A1	30,155,252	150,776	15,647	(31,370)	135,053	432,352
Worcester Forest Grove Middle	A1	18,125,496	90,627	9,405	67,841	167,873	346,568

Administrative Benefits

A pooled program would also provide several administrative benefits. By centralizing the issuance of School Building assistance debt, a pooled program would give the proposed School Facilities Commission a clearer sense of the amount available to support debt service grants. If the pool is able to achieve a lower than expected true interest cost in one issue, the Commission could add additional projects to the next issue without exceeding the SBA appropriation. The need to audit the communities post-issuance would also be eliminated by the new program.

The pooled program could relieve communities of the administrative difficulties of financing their own transactions. This would include providing on-going disclosure to the financial community, calculating arbitrage savings rebates, and investor relations. A pool would also provide communities with more flexibility in structuring their financing than they currently have under state finance law. The fact that a pooled issuance would sell in the institutional markets as well as the retail market would provide further structuring flexibility, since the retail market tends to prefer a standard product with a relatively short maturity. The longer-term bonds do not sell well in the retail market, often forcing municipalities to repay their principal relatively quickly.

Conclusion

A pooled financing program has many benefits. It would create a recognizable, attractive financing vehicle for investors, resulting in debt service savings for the Commonwealth and cities and towns. It would allow for a streamlined financing process, lowering costs of issuance and administrative costs. It would provide access to innovative market opportunities, including new markets of investors for school debt and new financing techniques. Finally, it would allow the Commonwealth to more effectively manage the issuance of School Building Assistance bonds and gives communities many more options in structuring their debt.